Economics of Taxation within a Federal Context

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Abstract

The economic principles regarding taxation in a federal context are re-examined in the context of European tax harmonisation. It is suggested that the concept of subsidiarity could be more helpful in progress towards successful harmonisation if it were developed to take more account of these principles.

Key words: Taxation, fiscal federalism, European tax harmonisation

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Alexis de Toqueville suggested that "The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations".[1] However there remain important questions about how these different advantages might be combined and, in this context, paid for. The topic of 'fiscal federalism' has developed many important insights but there are further important applications such as the developing tax arrangements of the European Union.

The analysis of taxation with respect to multilevel government involves the usual economic considerations but with some important extensions. One is the economic role and degree of autonomy permitted to lower levels of government. The second is the issue of which taxes are most suitable for which levels of government – which has been referred to as the "tax-assignment problem".[2] In terms of the UK these topics have been a long term issue. As Foster et al. suggested:

> The recurrent crises, so called, in local finance which have been a feature of the last hundred years have sometimes led to modification of the system. But though very often there has been much talk about more fundamental changes, the ending of the crisis has usually meant the shelving of the talk.[3]

The implementation of the ill-fated local community charge introduced in 1989 in Scotland and 1990 in England and Wales, even led to civil disobedience including rioting in London and were a contributory factory in the events leading to the resignation of Mrs Margaret Thatcher as Prime Minister.[4] At a European level the current manifestation of these issues has been the slow and uncertain progress towards 'tax harmonisation'[5] and, as in the UK case, there seems to be a long way to go before a satisfactory solution is achieved.

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[1] Alexis de Tocqueville, *Democracy in America*, first published in 1838 and quoted by Oates, W.E. "An Essay on Fiscal Federalism" (1999) 37 *Journal of Economic Literature*, at 1120.
[2] McLure, Charles E. Jr. ed. *Tax Assignment in Federal Countries*, Australian National University, Canberra, 1983.
[3] Foster, C.D., Jackman, R.A. and Perlman, M. *Local Government in a Unitary State*, Allen & Unwin, 1980 at 600.
[4] Gibson, J., *The Politics and Economics of the Poll Tax: Mrs Thatcher's Downfall*, EMAS, 1990.
[5] For example, see James, S. "The Difficulties of Achieving Tax Harmonisation: The Case of the European Union", (2000) 4 *Asia-Pacific Journal of Taxation* 42 and James, S. "Can We Harmonise

Internationally there are different arrangements with respect to multilevel taxation. For instance, in the USA the different levels of fiscal responsibility include the federal government, fifty state governments, the District of Columbia and about 80,000 local jurisdictions. Australia, Canada and Germany provide further examples of three-level arrangements. The UK basically has a two-tier system with parishes no longer having a significant financial role in local government.

The UK is a unitary not a federal state and the only power local authorities have is based on what the central government will let them have. In federal countries lower tiers have constitutionally established roles. However, in both types of arrangement the similar questions arise regarding multilevel government and taxation. Another interesting situation at the other extreme is that of the European Union where there is a "bottom-up" approach as Member States move in fits and starts towards more "harmonised" tax arrangements.

To analyse the economics of federal taxation this paper starts with the economics of multilevel government in Section 1 followed by the economics of multilevel taxation in Section 2. Section 3 discusses the criteria that might be helpful in considering which taxes are appropriate for lower jurisdictions. Sections 4 and 5 then discuss two cases – that of the United Kingdom and the European Union. Finally Section 6 draws some conclusions.

1. The Economics of Multilevel Government

The economic justification for government intervention in a market economy is that there are some activities where the public sector might provide a more appropriate economic solution than the private sector is likely to achieve. The theoretical justification for this approach is described for example by Musgrave[6] and Oates.[7] Some of these economic activities are best dealt with at the highest level of government, others at lower levels. Policies relating to the economy as a whole, such as those involving aggregate levels of demand and supply, the issues of

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Our Views on European Tax Harmonisation?" (2000) 54 *Bulletin for International Fiscal Documentation*, 263.

[6] Musgrave, R.A. *The Theory of Public Finance*, McGraw-Hill, 1959.

[7] Oates, W.E. *Fiscal Federalism*, Harcourt Brace Jovanovich, 1972.

unemployment, inflation and the balance of payments, are generally best dealt with at the highest level of national government. This is also because such policies should be co-ordinated with the policies of the monetary authority. Policies relating to the desired distribution of income and wealth are also often best dealt with at the highest level partly because they are likely to affect the whole population and partly because income and wealth are unlikely to be distributed evenly across a country. The provision of some public or 'social' goods might, depending on their nature, be best supplied at national level, for example defence, or at a local level, for example parks and other public amenities.

The existence of public goods has long been recognised, for example by Adam Smith in the Eighteenth Century. Although his work is more usually quoted by free-market enthusiasts, Smith was also very clear that the government has the:

> duty of erecting and maintaining certain public works and certain public institutions which it can never be in the interest of any individual or small number of individuals to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.[8]

In contemporary economic analysis, the technical definition of a pure public good has two aspects. One is that it is non-excludable, that is individuals cannot be charged directly for consuming a public good such as national defence or public health and so it has to be provided collectively. The other is that, once it is provided, everyone can benefit at no extra cost so it is not economically efficient to charge for its consumption, even if this were possible. There are very few pure public goods, but many have elements of one or both of these characteristics.

Furthermore the public sector often supplies, or encourages the supply of, goods and services that do not necessarily fit the public good definition but which are considered to have sufficient merit to deserve a higher level of provision than might otherwise be available, particularly to those on modest incomes. Examples of such 'merit goods' include education, health and some cultural activities such as the arts.

[8] Smith, A. *The Wealth of Nations*, 1776, Cannan ed., Methuen, 1950, Bk. IV, Ch. IX, p. 185.

The demand for public and merit goods may not be the same in all areas of a political entity. For instance, areas with a large proportion of retired inhabitants or one with a large proportion of children might well have very different demands on the public sector than one with a more even distribution of across age groups. It is just as possible for varying demands for public goods to exist between groups with different regional and cultural traditions. The economic argument is therefore that communities might be better served if there is an element of choice as regards the level of consumption of public and merit goods in different areas.

Another argument for lower tiers of government is that local administration might be better informed than central government about the best ways to meet local needs. There is also an accountability argument for lower tier taxation. Local public spenders might be more careful in their expenditure if they are accountable to local taxpayers than if the money simply came as grants from national funds.

The seminal work analysing how economic welfare might be increased by different local tax and public spending regimes was produced by Tiebout.[9] A great deal more has been done since then. For example, Inman and Rubinfeld[10] reviewed the literature on the design of tax policy in federalist economies and consider different constitutional rules. Prudhomme[11] examines some of the drawbacks of fiscal decentralisation and Alesina *et al.* discuss some possible reconciliations between the gains from large fiscal units and an empirical observation of a tendency towards political separation.[12] Several aspects of fiscal decentralisation are examined by Bird[13] and particular issues include the deductibility of lower-level taxes from higher level liabilities,[14] the effects on the overall size of the public sector[15] and tax competition.[16]

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[9] Tiebout, C.M. "A Pure Theory of Local Expenditures" (1956) 64 *Journal of Political Economy* 416.
[10] Inman, R. P. and Rubinfeld, D.L. "Designing Tax Policy in Federalist Economies - An Overview" (1996) 60 *Journal of Public Economics* 307.
[11] Prudhomme, P. "The Dangers of Decentralisation" (1995) 10 *World Bank Research Observer* 201.
[12] Alesina, A., Perrotti, R. and Spolaore, E. "Together or Separately - Issues in the Costs and Benefits of Political and Fiscal Unions" (1995) 39 *European Economic Review* 75
[13] Bird, R.M. "Threading the Fiscal Labyrinth - Some Issues in Fiscal Decentralisation" (1993) 46 *National Tax Journal* 207.
[14] Kaplow, L. "Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax" (1996) 82 *Virginia Law Review* 413
[15] Persson, T., and Tabellini, G. "A European State - Lessons from Existing Federations - Does Centralisation increase the size of Government?" (1994) 38 *European Economic Review* 765.
[16] Bucovetsky, S., "Rent Seeking and Tax Competition" (1995) 58 *Journal of Public Economics* 337.

Fiscal federalism also has implications for macroeconomic policy[17] and optimal tax design[18] but these will not be addressed in this paper.

2. The Economics of Multilevel Taxation

In considering the economics of multilevel taxation, it should be pointed out, as Hagemann *et al.*[19] have, that tax systems often do not even meet the basic economic criteria of efficiency and equity against which taxes may be judged. Nevertheless it still helpful to consider the main criteria[20] that can be used to judge economic merits of a particular tax and how these might be modified to take account of multilevel taxation.

As with public spending, there may be cultural and regional differences regarding taxation in different areas. For instance, in the European context, different countries have different views about the level of taxation on tobacco. Similarly Northern European countries tend to tax alcoholic beverages more heavily than the European Union average and the main wine-producing countries tend to tax wine relatively lightly. This may be a result partly from different choices as regards the best combination of taxes in terms of direct and indirect taxation, but it might include a deliberate policy of discouraging the consumption of alcoholic drink by this means. Also, there might well be straightforward national interest involved. For example the European Court has had to intervene in a range of such cases as in the so-called 'spirits cases'. Several countries were found to have discriminatory taxes in breach of Article 95 of the Treaty of European Union - France for having favourable tax rates for cognac over whisky, Italy grappa over rum and Denmark aquavit compared with other spirits.[21]

The main criteria for analysing taxes or possible tax reforms in general are efficiency, equity, stabilisation and some economists have also taken administrative considerations into account. These will be summarised in turn.

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[17] Allsopp, C., Davies, G. and Vines, D. "Regional Macroeconomic Policy, Fiscal Federalism and European Integration" (1995) 11 *Oxford Review of Economic Policy* 126.
[18] Gordon, R. H. "An Optimal Taxation Approach to Fiscal Federalism" (1983) 98 *Quarterly Journal of Economics* 567.
[19] Hagemann, R.P., Jones, B.R. and Montador, R.B. , "Tax Reform in OECD Countries: Motives, Constraints and Practice" (1988) 10 *OECD Economic Studies*.
[20] For a fuller examination see James, S. and Nobes, C. *The Economics of Taxation*, 7th ed. updated, Prentice Hall, 2002.

Efficiency

For a tax to be considered economically efficient, it should not distort economic behaviour of consumers and producers. This includes possible disincentives to work, save and invest as well as decisions about buying and selling particular items. Economic efficiency is about maximising economic output given the resources available to the community. This is not just maximising production but also producing the goods and services that consumers value most. There are countless examples throughout an economy of distortionary behaviour caused by taxation and a great deal of economic tax research has been undertaken into this area relating to the effects of different taxes in different circumstances.

Some of the economic research in this area is very technical but general conclusions can be drawn, subject to a number of limitations and exceptions. In *efficient* markets*,* taxes that have a wider base are less likely to create distortions than those with a narrower base. Thus a tax on all goods and services is likely to be less distortionary than taxes on only a limited number of goods and services. With *inefficient* markets, there may be scope to use taxation to guide economic behaviour in the right direction. For example, some economic activities, such as those causing pollution, impose costs on the wider community and a possible remedy might be some form of tax designed to give incentives to avoid such costs.

In terms of multilevel taxation, in efficient markets economic activity might be distorted by different rates of tax in different local jurisdictions. Thus local sales taxes might divert trade to lower tax areas. This might not matter so much in geographically large countries such as the USA or Australia but it could be a major consideration for much smaller ones such as the UK. It might also be important in Europe as a whole where there are many countries very close to each other and such tax avoidance has become a major activity. Possibly the best known example are 'booze cruises' undertaken mainly to allow UK consumers to benefit from lower continental taxes on alcohol and tobacco.

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[21] Weatherill, S. and Beaumont, P., *EC Law,* Penguin, 3rd ed. 1999, at p. 480.

However, where there are inefficient markets some forms of corrective taxation might be more appropriately levied at lower levels of government. For instance, there is the growing awareness of the possible benefits of the use of congestion charges to ration scarce road space. As the circumstances relating to such a tax vary from area to area, in this respect, it might be a suitable tax for local rather than national levels of government.

Equity

Although this topic covers a number of dimensions, the main area of interest in the present context, is what constitutes a 'fair' tax. The definition of 'fair' is, of course, at least partly a matter of opinion. However, some progress has been made using concepts such as horizontal equity which suggests that people in similar circumstances and with the same taxable capacity should be taxed in the same way. Another concept is vertical equity which suggests that those with differing taxable capacities should contribute different amounts. This overall 'ability to pay' approach includes the 'sacrifice approach' to taxation discussed by earlier economists such as Mill[22] and Pigou[23]. According to the sacrifice approach, individuals' tax liabilities should be linked to the sacrifice of utility involved in their tax liabilities. Although it might be thought that those on higher incomes would have a lower marginal utility of income than those on lower incomes have, this is not necessarily true. There is therefore no single scientific prescription as to how this approach would translate, for example, into the most desirable degree of progressivity of a tax system – see for instance Blum and Calven[24]. Other relevant concepts include the 'benefit approach' to taxation - that individuals should pay tax in line with the benefits they receive from public expenditure. This has also been discussed by earlier economists such as Smith and Mill but this approach has a number of limitations. Not the least of these is the difficulty of estimating such benefits.

With respect to multilevel taxation there are several considerations. One is that the level of per capital income and wealth usually varies significantly in different regions within any country. A policy of redistribution therefore has to have a major national

[22] Mill, J.S., *Principles of Political Economy*, Longmans, London, 7th ed., 1871.
[23] Pigou, A.C., *The Economics of Welfare*, Macmillan, 4th ed., 1932.

dimension in order to channel resources from areas with the highest resources to those with the highest needs. However the benefit approach suggests that regions choosing a higher level of public spending should contribute in the form of higher taxation. If there are clear regional differences in views regarding redistribution then there is a case for part of this policy to be determined at a regional level.

Stabilisation Policy

There is a clear case for the government to promote macroeconomic policy objectives relating to variables such as the levels of employment and inflation.[25] There are several considerations as to the optimum level at which such policies should be developed and implemented, and some controversy. It seems reasonably clear that in the UK such policies should not be devolved below the national level. In contrast the European Union might still be too diverse economically for such policies to be successfully managed centrally.

Administrative Considerations

Much of the economic work on the administration of tax has been empirical studies of administrative and compliance costs. Generally the term administrative costs has been applied to the costs to the public sector of operating a tax and compliance costs to the expenses the private sector incurs in complying or not complying with the tax. Relatively high administrative and compliance costs do not necessarily offset all the benefits of a particular tax but they should also be taken into account.

3. Criteria for Assessing an Appropriate Lower Level Tax

In addition to the criteria summarised above, there are several additional ones that might apply to a good local tax. These include the need for a substantial and reasonably evenly distributed tax base and that it should be possible for different jurisdictions to vary the tax.

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[24] Blum, W.J. and Kalven, H. *The Uneasy Case for Progressive Taxation*, University of Chicago Press, 1953.

[25] See, for example, HM Treasury, *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, Palgrave, 2002.

A Substantial Tax Base

Assuming the lower level jurisdictions are intended to have a significant role, their source of revenue should also be significant.

Reasonably Evenly Distributed Tax Base

Local taxes should also be reasonably evenly distributed across jurisdictions to avoid revenue sharing arrangements that might reduce the benefits of tax and spending decisions being made at a local level.

Variable Rate

A good local tax should also be capable of being levied at different rates in different jurisdictions.

4. The UK Example

The relatively recent example of UK reform of local government taxation has a number of lessons but one in particular is the importance of equity in the criteria for an acceptable tax.

Traditionally the most important local tax was rates on occupiers of land and buildings. This tax has an ancient ancestry and can be traced back to the compulsory poor rate raised under the Elizabethan Poor Relief Act of 1601 and indirectly to even earlier taxes. In their modern manifestation local rates were a property tax levied on the "rateable value" of property. Domestic ratepayers were charged at a lower rate than non-domestic taxpayers and there were also rebates for individuals on low incomes.

Although rates aroused some quite vocal opposition from some ratepayers, in terms of the criteria discussed above, this tax scored quite highly. The efficiency criteria was more successfully met than it would have been by many other potential local taxes because, of course, existing property cannot normally be moved to lower taxed areas. The administrative and compliance costs were also low and rates were not considered to provide significant disincentives to work, save and invest. In terms of equity it has been argued that the amount spent on housing is (at least loosely) linked to income and wealth and rate rebates were available to the less well-off. It has also been argued that a tax system may be progressive overall without every tax individually also having to be progressive. Finally, to the extent that rates were levied on housing, their impact might have been partly offset by income tax and capital gains tax concessions to owner-occupiers.

Nevertheless, local authority rates were subject to considerable criticism over the years. The issue of fairness was frequently raised and it was said that rates did not take an individual's ability to pay into account and were regressive. Other criticisms came from local authorities themselves, who complained that rates were not a buoyant source of revenue and that they were too unpopular to raise the increasing income they needed. Such criticisms were recorded in the reports of successive government enquiries into local government finance.[26]

The debate covered the usual ground but there was an additional consideration. From the time of its original election in 1979 the Conservative Government had struggled to control the level of public expenditure of which, of course, local government expenditure is a large part. It was felt therefore that a tax was needed that would make it clear to local electors how much of their money local government was spending. Although rates were acknowledged as a highly perceptible tax, they were actually paid by only a proportion of the local electorate. There was the possibility, therefore, of a majority of non-ratepayers voting for a high level of local expenditure with no immediate concern about how it would be financed.

The government therefore looked for a tax that promoted local accountability more effectively. The argument was that "a substantial proportion of electors [should] have a direct interest in the decisions of their authority" and "there should be a clear link between changes in [local] expenditure and changes in the local tax bill".[27] On this basis a local sales tax was rejected, among other reasons, because it would not be perceived directly by those able to vote in local elections. Similarly the government rejected the possibility of a local income tax because, while there were over 35 million voters, there were only 20 million income taxpayers (though this counted

[26] Layfield, F. *Local Government Finance*, HMSO, Cmnd. 6453, 1976.
[27] Department of the Environment, *Paying for Local Government*, HMSO, Cmnd. 9714, 1986, para. 3.12.

married couples as one unit: at the time there were nearly 24 million individuals paying income tax). However, to try to ensure that as far as possible all voters contributed something to the costs of local expenditure, the government decided to introduce a "community charge" levied at a flat rate per person.

The Community Charge or Poll Tax.

A review of the arguments relating to a poll tax can be found in Smith.[28] Interestingly enough, like local authority rates, the poll tax meets most of the economic criteria for a good tax. Since it is levied at a flat rate per person, it does not distort consumer choice nor incentives to work, save and invest. In principle at least, it has low administrative and compliance costs since essentially only the existence of the taxpayer has to be established. In terms of a local tax it also generally scores well. The tax base is well distributed since a local authority perhaps ought to be considered as the population rather than a geographical area. Also, as it later proved, it was perceptible.

However it failed on the criterion of equity and in its own turn had to be replaced.

The historical precedent had not been encouraging. The Rising of 1381originated from a hatred of the poll tax.[29] The Archbishop of Canterbury who, as Chancellor of the realm represented the government, was beheaded by Wat Tyler's men on Tower Hill and, quite remarkably, the rebels captured London itself. Clearly the poll tax scored highly on the criterion of perceptibility.

The modern version of the poll tax was not related to taxpayers' ability to pay. The lessons include not only that fairness is one of the most important characteristics of a tax but that one which is considered to be unfair becomes difficult to administer and therefore expensive to collect. Although the experience of 1381 was not repeated in quite the same way, the country faced a considerable anti-tax campaign that included civil disobedience and a major riot in London. Alternative forms of local taxation were quickly reviewed and proposals for the replacement of the community charge with a new council tax were rapidly advanced.

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[28] Smith, S. "Should UK Local Government be Financed by a Poll Tax?" *Fiscal Studies*, 1988.
[29] Trevelyan, G.M., *English Social History*, 2nd ed., Longmans, Green and Co. 1946

5. The Case of the European Union and "Tax Harmonisation"

The economics of taxation within a federal context may also usefully be applied to the case of the European Union. As already indicated, this is an interesting as well as important example since progress towards overall system of taxation is the result of interaction between Member States. Progress has been slow and uncertain but can give an insight into the difficulties of achieving a co-ordinated regime by this means and the pressures for different possible solutions. Furthermore the process has been cast in the form of tax harmonisation between the tax systems of Member States rather than a more formal and rigid system set up by a central government.

The Case for Harmonisation

Early on, the Treaty setting up the European Economic Community was "very cautious"[30] in respect of tax harmonisation, which might reflect an appreciation of its importance to individual Member States. It began carefully with "provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market".[31] This was clearly necessary, of course, because otherwise the abolition of customs barriers to trade could be replaced by internal taxes that continued to discriminate against imports from other Member States.

There are also some linked arguments for harmonisation. One consequence of differences in tax systems is the increased scope for tax avoidance. Apart from moving goods and services around for tax reasons there are also financial possibilities, for example "thin capitalisation" refers to the practice of financing foreign operations through debt rather than equity so shifting tax liability from high tax countries to low tax countries.[32] The main disadvantage of such tax avoidance is the loss of revenue which ultimately means a greater burden for other taxpayers or lower public spending or some combination of both.

[30] Moussis, N. *Handbook of European Union*, Edit-Eur, 1994 at 143.
[31] Article 99 EEC as replaced by Article 17 SEA.
[32] For further discussion see Sommerhalder, R. A. "Approaches to Thin Capitalisation" (1996) 36 *European Taxation*, 82.

A further consideration is known as "tax competition".[33] This describes a policy of particular tax jurisdictions to use tax concessions to encourage businesses and individuals to locate in their areas. At one extreme complete "tax holidays" may be granted whereby companies or individuals with particular skills are granted exemption or favourable tax treatment for a period following their move to a new country. While such a policy may improve economic performance in the host country, this is likely to be at the expense of the countries losing the businesses and individuals. With respect to value added tax, Fehr *et al.*[34] described possibilities which could favour low tax countries at the expense of their European partners. Kirchgassner and Pommerehne[35] found that individual income tax competition had some influence on the distribution of high income individuals across different regions. In Canada, Rounds[36] reports that some provinces have been threatening to move away from the nearly uniform system of income and corporate taxation in order to assist economic development. Clearly tax competition is not consistent with a policy of free movement of capital, persons and so on. Nor is it consistent with a stable and equitable social structure across the countries involved.

However, it has been suggested that tax competition is unlikely to lead to significant differences in European tax regimes. The argument holds that in a single market no Member State will be able to maintain a tax regime that allows capital, and tax revenues to be enticed away by more favourable regimes elsewhere.[37] It has also been pointed out that tax competition and harmonisation are not necessarily in conflict in many circumstances.[38] Nevertheless, it should be said that this line of argument is not totally convincing.

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[33] For example see Coates, "Tax Competition among Jurisdiction with public and private employment", *National Tax Journal*, Vol. XLVI, 1993, No. 2, pp. 177-189.
[34] Fehr, H., Rosenberg, C. and Weigard, W. "Value-Added Taxation in the EC After 1992 - Some Applied General Equilibrium Calculations" (1993) 37 *European Economic Review* 1483.
[35] Kirchgassner, G. and Pommerehne, W.W. "Tax Harmonisation and Tax Competition in the European Union - Lessons from Switzerland" (1996) 60 *Journal of Public Economics* 351.
[36] Rounds, T. A. "Tax Harmonisation and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries" (1992) 22 *Publius: The Journal of Federalism* 91.
[37] For example, see Ernst & Young, *The Future of Corporate Taxation in the European Community,* Kogan Page, London, 1991 at 41.
[38] Rounds, T.A. "Tax Harmonisation and Tax Competition - Contrasting Views and Policy Issues in 3 Federal Countries" (1992) 22 *Publius - The Journal of Federalism* 91.

Definitions of Tax Harmonisation

Although the term "tax harmonisation" is frequently used the European approach to fiscal federalism, there do not seem to be many comprehensive definitions. Dosser[39] restricted tax harmonisation to "tax co-ordination among nations in the process of integration in a customs union or economic union" but this definition is no longer adequate to cover the full current use of the term. As Prest[40] argued, "co-ordination" is essentially a low-level meaning of harmonisation because it could be interpreted as no more than some sort of consultation process about organising tax systems in a similar sort of way. Rounds[41] suggests that harmonisation "refers to any situation where differences in taxation between the states (or provinces) are reduced either by co-operation among the states or by a federal government policy" but acknowledges that a completely uniform tax system may "not be optimal or practical." Peggy Musgrave[42] suggested a more open definition, based on ends rather than on precise institutional arrangements, namely: "Fiscal harmonisation may be viewed as the process of adjusting national fiscal systems to conform with a set of common economic aims".

Hitiris[43] takes a wider view of the term and describes two approaches to tax harmonisation - the *equalisations* approach and the *differentials* or *fiscal diversity* approach. Essentially the equalisations approach is that each country ends up with the same tax system. The differentials approach allows each country to use its tax system as a tool of policy in achieving major economic aims. This might be crudely summarised as saying that harmonisation can mean that either different countries' tax systems become the same or they remain different, so some further exploration of the term is required.

The International Tax Glossary published by the International Bureau of Fiscal Documentation (IBFD) defines harmonisation of tax as "the process of removing

[39] Dosser, D. *British Taxation and the Common Market*, Charles Knight, 1973.
[40] Prest, A.R. "Fiscal Policy" in P. Coffey (ed.) *Economic Policies of the Common Market*, Macmillan, 1979 at p. 76.
[41] Rounds, T. A., "Tax Harmonisation and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries" (1992) 22 *Publius: The Journal of Federalism* 91 at 92.
[42] Musgrave, P.B. "Harmonisation of Direct Business Taxes: A Case Study" in C.S. Shoup, *Fiscal Harmonisation in Common Markets*, Volume II, *Practice,* Columbia University Press, 1967 at 210.

fiscal barriers and discrepancies between the tax systems of the various countries comprising the European Union".[44] There is no convincing reason to confine tax harmonisation to Europe, but otherwise this definition provides a useful starting point. The first part of the IBFD definition, removing fiscal barriers, essentially refers to the promotion of a free trade area. It implies that imported goods and services within a free-trade area should not be subject to any fiscal discrimination in comparison to domestically produced goods and services. It is the aspect that was the focus of the first main moves towards European tax harmonisation.

The second aspect - "removing...discrepancies between tax systems" - is more open. Harmonisation could be taken to mean bringing into harmony or agreement; reconciliation or standardisation.[45] Complete harmonisation might imply that each country had exactly the same tax system. This would mean that each country had the same taxes, for example, value added tax, imposed on the same tax base, that is the same goods and services were subject to tax in each country. It would also mean that the same tax structure, that is the same rates of tax, were applied in each country.[46] However, harmonisation might be considered to be something involving less standardisation - more in terms of tax systems operating in "harmony" in the sense of making up a consistent and orderly whole, without each part being identical. Following this fiscal federalism approach, the question becomes how far differences in taxes between countries may be consistent within an overall situation of tax harmonisation.

It therefore seemed worthwhile to analyse the possible meanings of tax harmonisation further. There are several possible dimensions including the taxes levied, the tax bases, the rates of tax and the ways in which taxes are administered. Figure 1 indicates a possible classification. At one extreme is the complete standardisation of taxes mentioned above. This means that each country has the same taxes, levied on the same tax bases at the same rates and this is shown following the right hand branch of Figure 1. At the other extreme is no harmonisation. Following the left branch of

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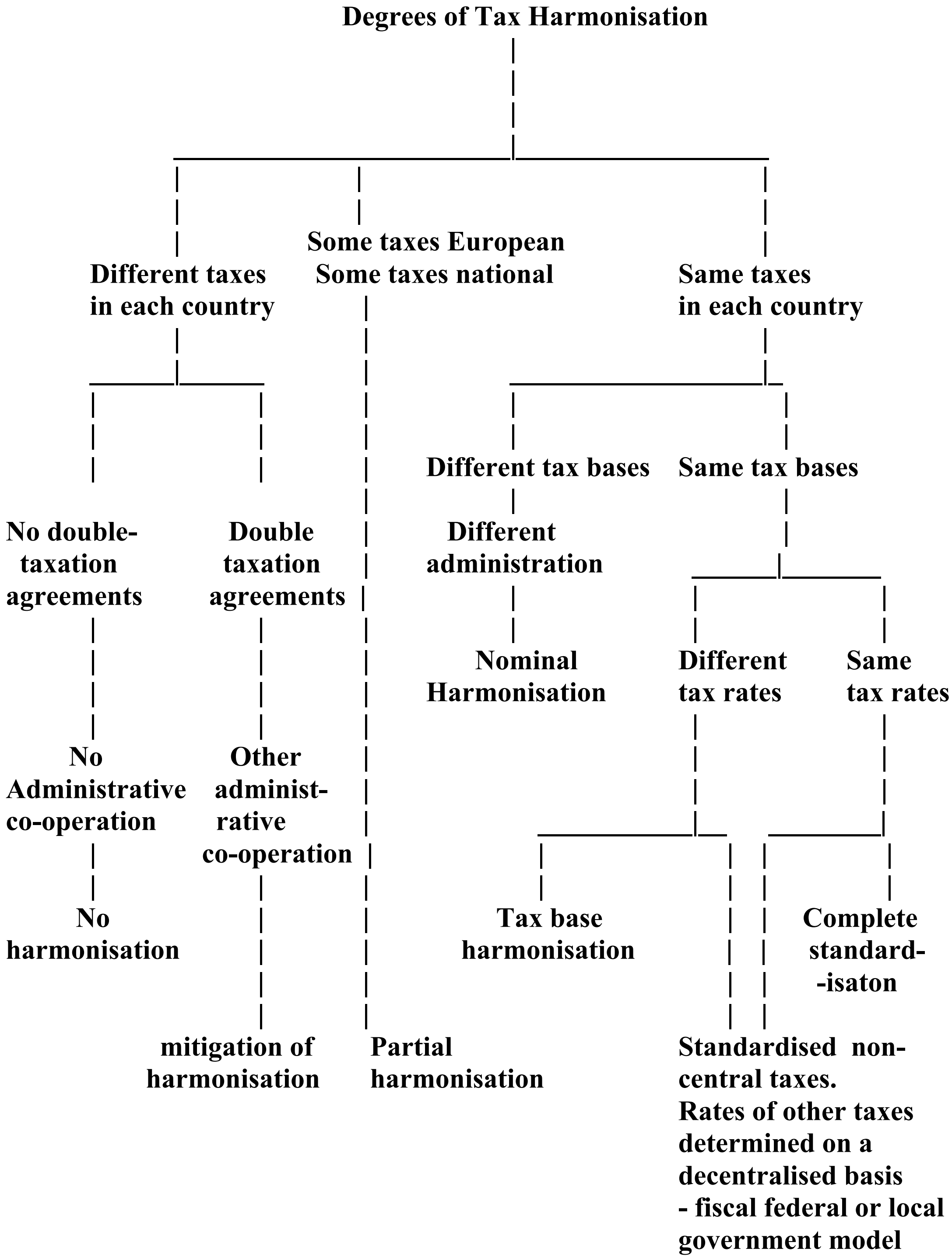
[43] Hitiris, T. *European Community Economics*, Harvester Wheatsheaf, 3rd ed. 1994.
[44] Lyons, S.M. *International Tax Glossary*, 3rd ed. International Bureau of Fiscal Documentation, 1996 at 153.
[45] Brown, L. (ed.) *The New Shorter Oxford English Dictionary*, Clarendon Press, 1993 at 1192.

Figure 1 this implies different taxes in different countries. It also implies no double taxation agreements. Administration considerations might also be important - for example involving co-ordination between the tax authorities in different countries over matters such as tax evasion. No harmonisation would also seem to imply no systematic administrative co-operation either.

[46] For further discussion of tax definitions and classifications see James, S. and Nobes, C. *The Economics of Taxation*, Prentice Hall, 7th ed. Updated, 2002, , Chapter 2.

Figure 1

Possible Classification of Degrees of Harmonisation



Degrees of Harmonisation

From this extreme situation of no harmonisation at all, it is then possible to develop the idea of degrees of harmonisation. One step forward might be some administrative co-operation between tax authorities regarding taxpayers with tax affairs falling within more than one tax jurisdiction. The next stage might be the development of formal double taxation agreements so that the same income is not taxed twice by two different tax jurisdictions. Although these might be described as forms of tax harmonisation, the term is normally used in a wider sense. In Figure 1, therefore, this situation is described as the "mitigation of non-harmonisation".

The middle solution would be to have some taxes levied in the same way across all countries in the European Union but Member States would also be free to impose other taxes of their choice. In other words, some taxes would be harmonised but not others. If this approach were preferred, there is much to be said on the relative merits of different taxes with respect to their suitability as taxes at the European or the Member State level.

The first major step towards a more comprehensive form of harmonisation is for countries to have the same taxes. This applies already to some taxes in the European Union, for example corporation tax, value added tax and income tax. However, there are considerable differences in their application in different countries and the result falls far short of full harmonisation. For example, the tax base is sometimes different. Each of the Member States has an income tax but the scope of the tax is different in different countries. In terms of indirect taxation, some goods and services are subject to tax in some countries but not in others. The method of administration might be different. For instance, each of the Member States has a form of corporation tax but they use different forms of the classical system and imputation systems.

Differences in administration may also be significant. For instance the United Kingdom has its unique cumulative Pay-As-You-Earn system[47] whereas other countries have different methods of withholding tax from wages and salaries.

[47] James, S. "Comparative Tax Systems: United States vs. Great Britain - Further Developments", (1995) 21(4) *International Tax Journal*, 81

Furthermore, there are different approaches towards tax compliance. There is scope for encouraging voluntary tax compliance[48] and some revenue authorities have made very positive moves in this direction.[49] Others have taken a more mechanistic view of taxpayer compliance. For example, Strumpel[50] and Schmölders[51] reported that the German tax system had been very rigid in its assessment procedures. This was in one sense efficient, but it also led to an expensive and confrontational tax system with a high degree of taxpayer alienation and resistance. There are also different methods of communicating with taxpayers[52] and future economic, technological social and political changes may affect tax administration differently in different countries.[53] It would therefore seem that administration as well as the tax base is a relevant dimension in considering the degree of tax harmonisation. As a result, in Figure 1 the situation where countries have the same taxes, but they are not levied on the same tax base, or by the same administrative methods, is described as "nominal harmonisation".

The next stage becomes more a little more complicated. The topic of fiscal federalism raises the question of the appropriate levels of government at which particular fiscal responsibilities might best be lodged. In the UK, for example, most taxes are levied on the same base and at the same rates nationally. Within that framework, as described above, there is the major local tax, now council tax but before that the community charge and before that local authority rates. Council tax is assessed on the same property tax base throughout the country but local tax jurisdictions have the power to vary the rate at which it is levied. Property is used in many countries as a tax base for local tax jurisdictions, partly because it cannot be moved to areas with lower taxes. However, some countries use a local income tax, sales tax or other taxes on a decentralised basis. Some countries have more than one local tax.

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48 Lewis, A. *The Psychology of Taxation*, Martin Robertson, 1982.
49 James, S. *Self-Assessment and the UK Tax System*, Research Board of the Institute of Chartered Accountants in England and Wales, 1995, Chapter 9.
50 Strumpel, B. "The Contribution of Survey Research to Public Finance" in A.T.Peacock (ed.) *Quantitative Analysis in Public Finance*, Praeger, 1969.
51 Schmölders, G. "Survey Research in Public Finance: A Behavioural Approach to Fiscal Psychology" (1970) 25 *Public Finance*, 300.
52 James, S., Lewis, A. and Allison, F. *The Comprehensibility of Taxation: A Study of Taxation and Communications*, Avebury, 1987.
53 James . S. and Wallschutzky, I.G. "The Shape of Future Tax Administration" (1995) 49 *Bulletin for International Fiscal Documentation*, 210.

In Figure 1 this two-tier arrangement is referred to as the “local government model”. It might give an indication of a desirable level of tax harmonisation in the future of the European Union, with perhaps some taxes levied on a standardised basis throughout the union and others levied at different rates and perhaps bases in different Member States. Presently the greatest moves towards harmonisation have been with respect to indirect rather than direct taxation. Hitiris[54] suggests that in effect “it is tacitly agreed that at the moment harmonisation should not directly impinge on [personal income tax] which should remain subject to national sovereignty”.

The Limitations of the Case for Harmonisation

As already indicated, the difference between the EU approach and the more normal approach to fiscal federalism is the degree of sovereignty of the Member States and its interaction with overall aspirations towards European Union. This political dimension is also linked to some more subtle economic analysis that considers wider aims than just a single goal of unfettered free trade. The political aim of the European Community has been rather more than simply the creation of a free-trade area. The aim of establishing a common market and an economic and monetary union was to promote, among other things, “economic and social cohesion”.[55] The Treaty on European Union states explicitly not only that it “marks a new stage in the process of creating an ever closer union among the peoples of Europe” but also one “in which decisions are taken as closely as possible to the citizen”.[56] Terms such as “economic union”, “economic and social cohesion” and “ever closer union” imply the harmonisation of many arrangements including taxation. However, the provision that “decisions are taken as closely as possible to the citizen” is important.

One way of proceeding is in terms of European fiscal federalism is the concept of subsidiarity. The principle of subsidiarity was not explicitly described in either the Treaty of Rome or the Single European Act. However, it appeared implicitly in a provision inserted by the Single European Act namely that the “Community shall take action relating to the environment to the extent to which the objectives...can be

[54] Hitiris, T. *European Community Economics*, Harvester Wheatsheaf, 3rd ed. 1994 at 125.
[55] Article 2 EC (as amended by TEU).
[56] TEU Article A.

attained better at Community level than at the level of the individual Member States."[57] The Treaty on European Union broadened the provision so that it stated:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.[58]

The concept of subsidiarity allows for regional diversity within a Unified Europe. Bernard[59] suggested that "subsidiarity provides us with a framework for the understanding of the relationship between the Community and its Member States". González's [60] view was that "subsidiarity is not proportionality" but possibly a different way of doing things. Although the term "subsidiarity" has been used to challenge the expansion of Community activity, as Weatherill[61] points out, Article 3b cited above is concerned with the appropriate level at which things should be done. Brittan[62] described it as a "best level" test. Taxation could be one area in which some actions can be "sufficiently achieved" by the Member States particularly if their public sector needs and choices are different.

There is a view that subsidiarity might impede unification. Toth,[63] for example concluded that it will "weaken the Community and slow down the integration process" and Green[64] argued that subsidiarity is a concept which promises much and delivers little and is not therefore of much consequence to developments in the Community. Yet such arguments appear to discount the stresses and strains between central organisation and local circumstances. The peoples of Europe may wish for a greater degree of unification than has existed historically, but may not find complete unification of everything acceptable. As Cass[65] suggests, subsidiarity is a principle

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57 Article 130r(4) EC.
58 Article 3b EC.
59 Bernard, N. "The Future of European Economic Law in the Light of the Principle of Subsidiarity" (1996) 33 *Common Market Law Review* 633 at 665.
60 González, J.P. "The Principle of Subsidiarity (1995) 20 *European Law Review* at 357.
61 Weatherill, S. Cases and Materials on EC Law, Blackstone Press, 3rd ed., 1996 at 509.
62 Brittan, "Institutional Developments of the European Community" (1992) *Public Law*, 567 at 574.
63 Toth, A.G. "The Principle of Subsidiarity in the Maastricht Treaty (1992) 29 *Common Market Law Review* at 1105
64 Green, P. "Subsidiarity and European Union - Beyond the Ideological Impasse - An Analysis of the Origins and Impact of the Principle of Subsidiarity within the Politics of the European Community" (1994) 22 *Policy and Politics* 287.
65 Cass, D.Z. "The Word That Saves Maastricht? The Principel of Subsidiarity and the Division of Powers with the European Community" (1992) 29 *Common Market Law Review* 1107.

which is still maturing but it can help clarify the relationship between the Community and Member States and it has the potential to defuse conflict. It may make it easier for states to operate with a degree of if autonomy within a co-operative framework. In other words, it might provide the flexibility to make a closer union possible because it can accommodate a degree of heterogeneity. As Bernard[66] concludes, the "Union cannot avoid answering the calls for more decentralised decision-making. Subsidiarity permits this without calling into question the integrity of the Community legal order".

Some writers have gone on to relate subsidiarity to issues such as fiscal competition[67] and the co-ordination of indirect taxes in the Europe.[68]

6. Conclusion

The role of taxation in a federal context has been analysed previously but the importance of issues of equity have sometimes been underplayed. The whole topic has gained a new relevance in the context of European tax harmonisation. There are sound economic reasons why the tax system may incorporate differences in different areas or regions. However the discussion of European tax harmonisation has often appeared confused and no generally accepted definition of harmonisation has emerged. The concept of subsidiarity is helpful in this context and should be applied in the light of the established economic principles examined in this paper.

[66] Bernard, N. "The Future of European Economic Law in the Light of the Principle of Subsidiarity" (1996) 33 *Common Market Law Review* 633 at 665.
[67] Sinn, H.W. "How Much Europe? Subsidiarity, Centralisation and Fiscal Competition" (1994) 41 *Scottish Journal of Political Economy* 85.
[68] Smith, S. "Subsidiarity and the Co-ordination of Indirect Taxes in the European Community" (1993) 9 *Oxford Review of Economic Policy* 67.